RetireReady

Your 401(k) Is Not an ATM:

6 Things to Consider Before Taking a Loan from Your Retirement Plan

If you are considering taking a loan from your retirement plan to bridge a financial gap, pause for a minute. This is a major decision that should not be made lightly, as there are consequences that could affect your ability to fund your future retirement. Here are six things you need to be aware of before you borrow from your 401(k) savings:

1 You'll incur double taxation.

You will repay the loan with after-tax dollars, and because the interest you pay is not tax deductible, you will pay tax on it again in the future when you retire and start withdrawing funds from your account.

2 Your take-home pay will be reduced.

Most plans require you to start repaying the loan (via paycheck deductions) almost immediately after you borrow the money. Your loan payment will reduce your take-home pay, potentially affecting your ability to meet your monthly expenses.

3 Your taxable income may increase.

Most likely, you will reduce or eliminate your normal 401(k) contributions until you have repaid the loan. Your loan repayments are not tax deferred, and they do not reduce your taxable income like 401(k) contributions do. As a result, you could shift into a higher tax bracket until you repay the loan and begin to contribute to your retirement savings again.

4 Your repayment schedule will accelerate if you leave your company.

If you lose your job or leave the company, it's not uncommon for plans to require full repayment of a loan within 60 days. This could create additional unforeseen financial stress on your household.

5 Failure to repay by the deadline will trigger a taxable event.

Most 401(k) plan loans must be repaid within five years. If you do not repay your loan based on the terms of the loan agreement, your employer will treat the loan balance as a distribution, triggering income taxes and the 10 percent early withdrawal penalty if you are younger than 59½.

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6 You will lose the magic of compounding.

When you take a loan from your 401(k), you lose the ability to earn interest on that money, which can affect your total portfolio balance come retirement.

A Cautionary Tale

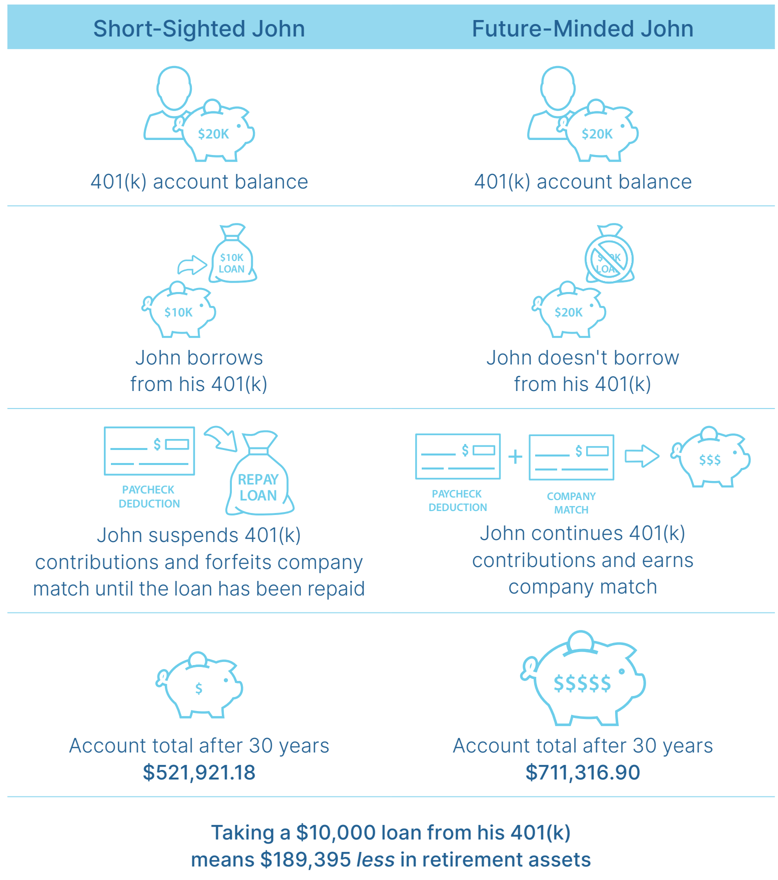
Your 401(k) plan is one of the best ways to save for retirement and help ensure your future security. Explore alternative options and consider all the implications before you take a loan or withdrawal from your employer-sponsored retirement plan. Otherwise, you may regret today's decision when you need this money most—at retirement.

Example: John has a balance in his 401(k) account of $20,000. John defers $300 per month (or $3,600 annually) of his pretax salary. His employer matches 50 percent of his deferrals, or $150 per month.

John decides to take a loan of $10,000 from his 401(k) account. The terms of the loan are $10,000 with a 6 percent interest rate and a repayment duration of 60 months.

Because John's loan repayments will come out of his paycheck and reduce his take-home pay, he decides to stop contributing to his 401(k) plan until the loan is paid off. In other words, he stops contributing $300 per month. This also means he doesn't receive the $150 that his employer is matching.

As a result, John has removed $10,000 from his account. In addition, he is no longer contributing $5,400 each year for five years ($3,600 in deferrals and $1,800 in match). Assuming those assets, if they had remained invested in his account, earned a 7 percent rate of return, the value of John's 401(k) account in 30 years would have been $711,316.90. Because they were not, his account value is only $521,921.18 and his lost opportunity is $189,395.72.



This is a hypothetical example and is for illustrative purposes only. Actual results will vary. No specific investments were used in this example, and it does not take into account deduction of fees or taxes. Investments are subject to risk, including the risk of loss. Past performance does not guarantee future results.

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